

# Benefits of using tax-exempt bonds

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- Low borrowing costs
  - All-in fixed rate borrowing costs are currently in the range of [ ]%
  - Variable rate borrowing costs have averaged under 4% over the past fifteen years
  - Access to low cost capital for potentially high cost projects
- Cultural institutions can potentially earn much higher returns on their endowments
  - Typical endowments have averaged over 9% in annual returns over the past 20 years
  - Keeps gifts or endowment funds invested

# Benefits of using tax-exempt bonds

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- Financing the project enables the entity to spread the costs of the project over the useful life of the project
  - May help with cash flow needs during capital campaigns
  - Ability to amortize costs over the life of a project
- The liquidity provided by the financing proves beneficial in:
  - avoiding construction delays
  - separating fundraising goals from construction needs

# Cultural institutions can borrow in the tax-exempt markets for qualified capital projects

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- Under federal tax law, 501(c)(3) exempt organizations may borrow on a tax-exempt basis
- Tax law requires that a governmental agency act as “conduit issuer” and issue bonds on behalf of the 501(c)(3) entity
- Federal tax law (“TEFRA”) requires
  - a noticed public hearing (14 day notice) and
  - governmental approval by city, county or state in which the project is located
- Under federal tax law, fundraising moneys and endowment must not have a “direct nexus” to the bonds or the project

# What costs can be financed with tax-exempt bonds?

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- **The Federal Tax Code is very specific in describing permitted uses for tax-exempt bond proceeds. Permitted uses include\***
  - *Capital costs*
    - Construction costs (including “soft costs”)
    - Equipment purchases to be made in the next 3 years
    - Other capital improvements
  - *Capitalized interest*
    - All interest payments due on the bonds during the construction period (e.g. two years of interest) and one year after completion may be financed with bonds
  - *Working capital*
    - Up to 5% of the bond issue may be used for operating costs
  - *Debt Service Reserve Fund (“DSRF”) (equal to one year’s debt service)*
    - If a DSRF is necessary, it may be funded with bond proceeds
    - DSRF amount is typically one year of principal and interest payments
  - *Bond insurance*
  - *Costs of issuance*

\*Bond Counsel will be the definitive authority on these matters; this discussion is provided as a general overview

## What costs are not eligible for tax-exempt bonds?

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- **Non-permitted uses include**
  - Operating costs (except those provided within the 5% working capital limit)
  - Equipment that will not be purchased within 3 years
  - Any buildings or equipment that will be used by a private company

# **Fundraising must meet certain standards to permit bond issuance**

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- Gifts should be made to the cultural institution's unrestricted endowment fund to enhance the cultural institution's long-term financial strength
- Any funds that are donated explicitly for the construction of the new facility must be used only for that purpose, and the bond issue must be reduced by the amount of the restricted construction gift
- Fundraising solicitation materials should be consistent with this approach and need to be carefully reviewed by bond and tax counsel
- The cultural institution should consider developing legally enforceable pledge of issue forms to enhance credit worthiness

# **Cultural institutions need to assure rating agencies, credit enhancers and investors that they can afford debt service on the bonds**

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- Market position
  - Competitive position and demand for services
  - Historical attendance and membership figures
  - Markets served
- Management of the entity
  - Board composition
  - Role of the board in setting financial guides and spending policies
  - Fundraising results and efficiency measures

## **Financial credit considerations include:**

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- Financial strength
  - Revenue diversity
  - Degree to which revenues cover operating budget
  - Projected growth in endowment assets
  - Restricted vs. unrestricted assets
  - Asset allocation policies and quality of investment pool
  - Endowment spending policies
- Debt capacity
  - Coverage ratios
  - Debt management policies